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Climate finance in developing countries

Reconciling the different views

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Key messages

In order to reach a global climate agreement that can be fully supported by poor developing countries it is essential to foresee an adequate arrangement for climate finance. This was already acknowledged at the 2009 COP15 in Copenhagen where industrial countries pledged to provide from 2020 onwards US$ 100 billion each year.

As long as ODA levels are rising towards the target of 0.7% it is feasible to achieve the commitments on climate finance in a way that is not at the expense of existing development finance.

Innovative finance should complement ODA and help to achieve more equitable climate funding. Innovative finance at the global level would be ideal to generate resources for the new Green Climate Fund.

Introduction

Industrial countries have made important pledges about climate finance. It is widely recognised that the countries most vulnerable to the effects of climate change are developing ones. Such countries will be hit the hardest and fastest by climate change, yet they have the least capacity and resources to cover the cost. But what is the relationship between Official Development Assistance (ODA) and climate finance and what are the bottlenecks to progress in climate negotiations in this area? This briefing note summarises some of the main views and provides suggestions on what could be a practical and feasible compromise.

In order to reach a global climate agreement that can be fully supported by poor developing countries it is essential to foresee an adequate arrangement for climate finance.

This was already acknowledged at the 2009 COP15 in Copenhagen where industrial countries pledged to provide from 2020 onwards US$ 100 billion each year for climate finance in developing countries. This would include “public and private funds and innovative finance”. In Copenhagen, industrial countries also promised fast start funding to the tune of $30 billion for the period 2010-2012.

Climate finance is essentially for two things. Firstly, mitigation is needed to limit further climate change, mainly through cutting the emissions of greenhouse gases. Secondly, adaptation is needed to cope with the effects of the warming that is inevitable, in particular in the poorest and most vulnerable countries.[i]

Industrial countries are assumed to pay for their own costs as well as to contribute to the needs of developing countries that arise from climate change.

Many questions remain unanswered

While the 'fast start' climate finance pledge for 2010-2012 was largely met (in particular because of the EU) many issues were still open or left in vague terms because it was not possible to agree on specific commitments.

Important elements that are not clear include:

- How to move from the fast start amount of $30 billion over three years to the $100 billion per year by 2020;
- What will be the share of public finance versus private finance and which flows can constitute private finance;
- How to distribute the cost of climate finance in a fair way across industrial countries;
- How to allocate the funds in a fair way across developing countries in need;
- Which innovative sources of finance can be considered - should these be universal such as a global CO2 tax or a levy on air tickets? Or should these come only from industrial countries?

Another issue arises in the funds needed to develop and diffuse new technologies for mitigation and adaptation. Such technologies can often be applied in both developing and industrialised countries. But for example, research on heat resistance of tropical crops is only applicable to developing countries. It is not easy to allocate research costs across countries.

It is possible to define criteria of fairness for the distribution of the climate finance costs across industrialised countries and for the allocation of funds over developing countries. But reaching an agreement on such criteria and applying them in practice is likely to be extremely difficult.

The costs for both mitigation and adaptation are inherently unclear, so their estimation is difficult. Not only do they depend on the various assumptions that must be made, but both types of cost are interlinked. If more mitigation is pursued, the needs for adaptation diminish. Overall it is fair to say that $100 billion is a "conservative estimate" of the climate finance needs of developing countries.

Two views on the role of development finance

Another open question is about the relationship between development finance - essentially Official Development Assistance (ODA) - and climate finance. This is one of the controversial aspects of the present climate negotiations. It will be difficult to reconcile the various views on this, but they will have to be reconciled because finance is a key part of the overall climate agreement.

In the climate negotiations, it is frequently stated that climate finance must be "new and additional". This is based on the wording in the United Nations Framework Convention on Climate Change (UNFCCC). One of the views expressed often by developing countries and civil society organisations is that climate and development finance are different categories and that they should be kept apart and accounted for separately.

Under this view the targets for development finance or ODA and for climate finance should be distinct. With the adoption of the Sustainable Development Goals (SDGs) in September 2015 to replace the Millennium Development Goals (MDGs), the ODA target remains 0.7% of GNI of industrial countries. This view could imply a separate specific climate finance target. For example, the G77 and China have called for 1.0% of GNI as a target. There is no broad agreement on such a target. We shall hereafter refer to this as View 1.

Another view - referred to as View 2 - is that, in terms of implemented activities, it is simply not possible to distinguish most of climate finance from development finance. A good deal of past ODA has supported food security in Least Developed Countries, which in many cases can be considered as support for climate adaptation in the agricultural sector. Several other types of ODA can also be seen as climate related. For example, disaster risk reduction, the promotion of renewable energy, reforestation and forest conservation. It is a fact that many development projects are linked to climate adaptation or mitigation and fully correspond to the definition of ODA.[ii]

In order to measure how much ODA is climate related the OECD/DAC has agreed on markers for the three Rio Conventions, including the UNFCCC. There are separate markers for climate adaptation and mitigation.

Briefly summarised it works as follows: if the main objective of a project is climate adaptation or mitigation it gets Marker 2. Projects for which climate change is an objective, but not the main one, get Marker 1 and the rest that are unrelated to climate get Marker 0. Virtually all the climate finance provided by industrial countries, including the $30 billion fast start finance agreed in Copenhagen, has actually been ODA and has been classified according to the Rio markers.[iii]

Can these views be reconciled?

The defenders of View 1 are especially critical of a situation where ODA funds that are not directly linked to climate change - say for example in health, education or infrastructure - are diverted or redirected towards climate finance. But also most of the defenders of View 2 would not like to see funds intended to support a legitimate development objective to be redirected to climate in order to reach the financial pledges in the climate negotiations.

It is immediately clear that in a situation where ODA budgets are declining, it will always be possible that some new item of climate finance was “at the expense” of other development finance. A reconciliation of View 1 and View 2 is therefore only possible when ODA budgets are rising.

With ODA rising over time, development priorities and finance can be kept intact and the whole or part of the increase can be devoted to climate finance. In this way climate finance is not “at the expense” of existing development finance. This can be considered as a way to respect the spirit of “new and additional funds” as stipulated in the text of climate negotiations. Hence, it is a way to reconcile Views 1 and 2.

If the ODA target of 0.7% would be reached by 2020, it is possible to deliver on the $100 billion pledge from the climate negotiations. This is easy to demonstrate. In 2013 ODA reached $134 billion, representing 0.3 % of the GNI of DAC members. In order to reach 0.7% of GNI, the required ODA would be around $313 billion - or an increase of $179 billion. In other words if DAC members would achieve their 0.7 % target (that was included in MDG8) they could fully cover the cost of the $100 billion pledged in Copenhagen without diminishing other development expenditure.

A further $79 billion additional funding for other development objectives would still be available. Moreover, the $100 billion should, in part, also come from the private sector or from innovative sources of finance – so ODA does not necessarily even need to reach the average 0.7% to achieve the climate funding pledge.

Will ODA increase in the future?

The reconciliation of View 1 and 2 is only possible when overall ODA finance is rising. What is the likelihood of this happening between now and 2020? Since the 1970s there has been a decline in the ODA as a share of GNI until around the year 2000. Since then, there have been a number of initiatives to make ODA increase and during most of this period there has been a modest rise in ODA.

At the moment six members of the DAC have reached or exceeded the 0.7 % target. These are Denmark, Luxembourg, the Netherlands, Norway, Sweden and the United Kingdom. [iv] Some other DAC members are not very far from the target. However following the financial crisis that started at the end of 2008, several DAC members have decreased their ODA.

Since 2014, the growth of many DAC members has increased somewhat, which would facilitate reaching the SDG targets that were agreed in 2015. Even though the share of ODA in total financial flows to developing countries is going down, there are good arguments to keep up the pressure to effectively reach the ODA target.

It is not possible to predict the future size of ODA. This will depend on a range of factors - most importantly the political will of the industrialised countries. The 0.7% target is certainly a feasible one, as demonstrated by the six countries that have achieved it. It is interesting to observe that some of these countries have higher growth rates and lower unemployment than the average of the DAC members. The explicit *recognition that "fresh" ODA can be used to fulfil the climate change finance pledges would provide a strong additional argument to increase ODA.*

The role of the private sector

While it was demonstrated in theory that ODA could cover the full financial pledges by industrialised countries of $ 100 billion, it is important to look at the other elements that were mentioned in the pledge ie the role of the private sector and innovative finance.

So far there has been little debate about the role of private sector climate finance from industrialised countries in developing countries themselves. The private sector could contribute by moving to green - 'climate friendly' - investments and by promoting innovative low-carbon technologies.

Unlike the public sector, the private sector will not provide grants. Rather, private companies can directly invest in developing countries or they participate in funds that make direct investments. It is necessary to agree upon which Foreign Direct Investment (FDI) or which participations would qualify as a contribution to climate finance.

While there has been an agreement on what constitutes climate finance within ODA (see above) there is not even a discussion on this in relation to the private sector. There are good arguments to include investment in renewable energy and in energy efficiency. It would also be possible to include private sector contributions to Nationally Appropriate Mitigation Actions (NAMAs) identified by developing countries.

At first sight, private sector contributions would only deal with mitigation. But there could also be private sector investment in adaptation. An example of this could be research to produce drought and/or heat resistant crops. The private sector could also offer climate insurance products in developing countries.

The private sector will not invest unless there are incentives to do so. This also points to combining or blending public resources in the form of grants with loans to provide incentives to the private sector to engage in productive climate friendly investment. Blending can speed up green investments for which there are not enough grant resources and that are not attractive to the private sector without some grants.

The private sector can also contribute under existing mechanisms such as the Clean Development Mechanism (CDM). Under the CDM the private sector can "buy" emission reductions in developing countries in order to fulfil its obligations in the industrial countries. For example, carbon intensive industries like pulp and paper could invest in reforestation or renewable energy in developing countries.[v]

The practice of CDM has not always lived up to the expectations and indeed several projects have been controversial. Furthermore as the world must (over this century) move to zero emissions, a mechanism like CDM or comparable mechanisms can never be a long-term solution. CDM can continue to have some role over the coming two or maybe three decades. The CDM experience could be useful to determine what constitutes climate finance by the private sector.

Role of innovative financing

Innovative finance is another way to increase the public resources for helping developing countries to cope with climate change. There has been a lot of reflection on innovative finance, not only in relation to climate change, but also for development in general.

A frequently mentioned proposal that is supported by a few governments is the financial transaction tax or Tobin tax.[vi] Some innovative mechanisms already exist in practice, but at the moment on a very modest scale.

For example, a few countries ask a levy on airline tickets and the funds are used for vaccination campaigns in developing countries.

Innovative finance has interesting implications for improving equity in relation to climate finance. For example it is not ideal when poor consumers in industrial countries must pay for climate finance in developing countries while *affluent* consumers in emerging countries would not contribute. Innovative finance that is truly global would deal with that issue.

A global CO2 tax would affect all the consumers in the world in the same way. A global CO2 tax would respect the principle that the polluter pays. Some specific assessments have been made for a much more modest proposal of a global airline ticket levy; a reasonable magnitude levy could already generate around $20 billion per year. This could make a lot of sense because emissions from air transport are the most rapidly rising and because those who can afford air transport are among the most affluent people and have the capacity to pay the levy. A global CO2 tax is attractive in theory, but very hard to implement, while an air ticket levy is easier and tackles a specific form of CO2 emission.

One of the outcomes of the recent climate negotiations has been the creation of the *Green Climate Fund* (GCF). Developing countries have great expectations that the GCF will become a major source for their climate finance needs. The GCF became operational in 2015 following an agreement on its governance structure which was reached after lengthy negotiations. A target size of $100 billion has been proposed for the fund, but this is an overall figure and not to be confused with the annual $100 billion by 2020 mentioned above. So far, the voluntary pledges by the industrialised countries cover around 10% of the target. It would be tricky to agree on exactly how much each industrialised country should contribute to this fund.

Another issue that is not yet openly debated is whether other high-income countries such as Brunei, Singapore or the United Arab Emirates should contribute. Therefore, *using a global innovative financing mechanism for the GCF would be the ideal situation*. In this way wealthy consumers, wherever they are, would contribute in a comparable way. The GCF should, in the first instance, support climate finance needs of the LDCs.

Conclusion

This briefing note pointed out some of the many unresolved questions in relation to the pledge by industrialised countries to provide $100 billion to help developing countries with climate finance every year from 2020 onwards.

One of the issues that must be resolved to reach a new climate agreement is the divergence of views about the relationship between development and climate finance. This Briefing Note offers a few pragmatic suggestions on how to bridge this divergence. As long as ODA levels are rising towards the target of 0.7% it is feasible to achieve the commitments on climate finance in a way that is not at the expense of development finance.

A wide recognition that ODA can indeed be used to fulfil the climate finance pledges would effectively provide a strong argument to increase ODA. It would also be a way to apply the lessons of ODA in terms of aid effectiveness. Keeping climate finance as a separate flow would invite the creation of new structures or institutions and would lead to inefficiencies due to a lack of experience.

In addition, the private sector should contribute by investing in renewable energy and energy efficiency in developing countries. There should be a reflection and agreement on what constitutes private climate finance. The blending of public grants with private investments can make an important contribution. Innovative finance should complement ODA and help to achieve more equitable climate funding. Innovative finance at the global level would be ideal to generate resources for the new Green Climate Fund.

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NOTES:

[i] There is also an issue about financing the cost of loss and damage for which adaptation is not possible. It is difficult to determine such costs, because it is hard to distinguish an extreme deviation from an unchanged climate from a deviation resulting from climate change.

[ii] Some climate finance cannot be classified as ODA, for example the finance under the Clean Development Mechanism (CDM) which is undertaken to fulfil emission reduction obligations in industrial countries. However, projects that are designed to build capacity in developing countries in relation to CDM project can still be considered as ODA. The EU and others have already undertaken a range of such capacity building projects usually focussed on the Least Developed Countries.

[iii] In order to define the total value of ODA climate finance it is necessary to make an assumption for the climate share of projects with Rio marker 1. This is an estimate because the share of climate finance can be different for every project. For many projects it will be impossible to determine the exact climate share. Some development agencies have used 40% as a reasonable assumption.

[iv] The United Kingdom reached 0.7% for the first time in 2013, while in that year the Netherlands was slightly below after having achieved the target for several years.

[v] Reforestation is presently not allowed for the private sector under the EU's Emission Trading Scheme. However reforestation is recognised under the CDM. Public sector agencies can submit reforestation projects. Non-EU private sector can also use it. In the future the EU regulations might change, for example allowing reforestation in LDCs.

[vi] Several EU Member States have expressed readiness to introduce a Financial Transaction Tax. However actual implementation is not expected in the near future, because of the fear that countries implementing such a tax will lose transactions to countries that do not have it.